



Finance and Leasing Association

International Accounting Standards Board Leases Exposure Draft ED/2013/6

FLA comments

1. The Finance and Leasing Association (FLA) represents the UK's providers of equipment finance arrangements. Our members include banks and non-bank finance companies, including both 'independents' and 'captive' finance companies owned by equipment manufacturers. In 2012 FLA members enabled £21.4 billion investment in new equipment for around 250,000 UK businesses. Around 75 per cent of the investment was made using finance leases or hire purchase arrangements, the remaining 25 per cent through operating leases or service arrangements. Most equipment leases are, therefore, already on lessees' balance sheets.
2. Our responses to the questions below are intended to reflect the situation specifically in the UK. We also support the wider and more detailed responses from our European association, Leaseurope.
3. In commenting on the ED, our focus is on the practicability of the proposals for both lessors and lessees. We start, however, with some more general points.

Objectives and process

4. Despite some improvements, the proposals remain insufficiently targeted and likely to damage to the use of equipment leasing in the UK. Around 95% of the value of leasing by large UK companies is property rather than equipment. The use of equipment operating leases by large companies in the UK is dominated by a very small number of businesses in the transportation and communications industries. Yet the most complicated and costly parts of the proposals are for equipment leases rather than property, and companies making routine use of low-value operating leases could face much higher preparation costs than the largest users of today's operating leases.
5. It has become extremely rare for an equipment lessee to be interested in 'structuring' to artificially alter the accounting classification of their leases. It cannot help the process of setting a high-quality standard when the IASB suggests otherwise in its statements. Setting a standard on the unproven assumption that preparers are ready to 'structure' leases not only leads to significant unnecessary complexity but also undermines the professionalism of members of the UK's accountancy bodies and audit firms.
6. It is insufficient to only compare the proposals with the existing rules. No-one would claim that IAS 17 as it is currently applied is perfect. There should also be a comparison made between the proposals and an improved version of IAS 17. An improved version might require preparers to provide higher quality notes on their use of operating leases, meeting the standards already achieved by some companies.

7. It is important the final standard should reflect at least the early part of the highly-relevant review of the IASB's conceptual framework. Any delay caused would, in the course of time, be seen as insignificant in the process of improving how leases are accounted for. Not doing this is very likely to lead to a new leases standard that is inconsistent with the new conceptual framework in critical areas such as the definition of the asset and liability and boundary between a lease and a purchase.

Complexity

8. The proposals have improved since the previous ED, with fewer accounting judgements (such as re-assessments) now being required, and a more logical approach to lessor accounting. However this work has not appeared to reduce the number of factors that need to be considered for each lease. As things stand, preparers would need to consider over one hundred points in accounting for each component of a lease (*see Appendix 1*). Many of these points would not be applicable to most leases or would result in no change to the numbers but would still need to be considered to satisfy auditors. The issue could be seen as more one of appearance than reality, but the rules as currently presented would be seen as an unacceptable burden by many lessees. Such a perception could damage the use of leasing, whether or not it is correct.
9. Most users, particularly the vast majority of analysts who will never be close to the details of the new rules, are unlikely to fully understand the numbers that come out of these complex proposals. It seems highly likely many will still choose to carry out their own analysis, starting by removing the leasing numbers from the accounts.
10. There are ways of reducing the complexity of the standard for preparers:
 - i. Including examples in the body of the Standard to show how straightforward leases, being those with no options to purchase or variable payments etc., would be accounted for. Bringing such examples into the body should help to allay concerns over complexity. Most importantly, it should be made clear that for leases meeting certain criteria as being 'straightforward', there should be no need to consider many of the steps set out in the Standard. This should help avoid auditors unnecessarily requiring preparers to demonstrate how they have considered each step.
 - ii. The flow of the paragraphs in the Revised ED does not always reflect how the standard would be applied in practice. It might be useful to present the rules in a more 'user-friendly' way.
 - iii. Finally, we would encourage the IASB to try to be a little less helpful! We understand from meetings with Board members and the staff that the length of the ED reflects a desire to help preparers and their auditors to interpret the principles that are shown in bold type. The effect, however, is to make the standard appear far longer and more complicated than necessary. We believe the non-bold sections of the ED extend far beyond essential guidance into interpretations.

Under the IFRS Constitution, interpretations should be left for the IFRS Interpretations Committee. There is the opportunity to greatly simplify the new standard by doing just that.

Question 1: Identifying a lease

11. Although the general principle of the “right to use” is now clear, there remain some areas of uncertainty at the margins between leases and services, and leases and purchases. Although from a technical perspective dealing with these uncertainties may appear to be ‘fine-tuning’ the proposals, this could have a very significant impact on the number of small equipment leases that will be categorised as leases.

Leases and services

12. We support the principle that fulfillment of a lease contract depends on the use of an identified asset. This should, in theory, result in many small business equipment agreements being classified as services rather than leases. That could significantly reduce the burden of the new rules for preparers and avoid unnecessary clutter in accounts.
13. Unfortunately the Basis for Conclusions (BC) (*at BC105b*) appears to rule out most small business equipment agreements being classified as services. The BC includes a requirement that a substitution clause must be “substantive”. It seems inevitable that this will result in auditors expecting to see evidence not only that there are no economic barriers to substituting alternative assets (*9bi*) but that substitution is happening on a regular basis. Substitution would only happen on a regular basis if there was a significant economic incentive to substituting alternative assets. These two tests are quite different. We understand some are concerned that the ‘no economic barriers’ test could lead to more substitution clauses being added to contracts as a form of ‘structuring’. We believe that would actually be the right result provided in those cases it was evidenced that there were no economic barriers to substituting alternative assets.
14. As well as clarifying this apparent inconsistency between the ED and the BC, we recommend the ED is amended to amplify the nature of the barriers to substitution test (*9b*). Many types of equipment are controlled using software programs that are configured to the needs of the customer. Substituting the equipment will involve transferring those configurations. This could be seen as a disincentive to substitution. It needs to be clear that the assessment of barriers should be based not on any individual barrier but rather on an overall assessment of the economic advantages and disadvantages of substitution.

Leases and purchases

15. There remains uncertainty over the line between leases and purchases. In the UK car market, for example, there are many variations of hire purchase. There can be automatic transfers of ownership, fixed option to purchase fees or variable 'balloon' payments based on the difference between the current value of the vehicle and a 'Guaranteed Minimum Future Value'. The likelihood of options being exercised depends significantly on the marketing policy of the car manufacturers and distributors toward the end of the minimum rental period, together with the state of the used car market at that time. It is often very difficult to assess if there is a significant economic incentive to exercise an option one or two years in the future.
16. The separate discussion over definitions of assets and liabilities as part of the Review of the Conceptual Framework for Financial Reporting should help define the line between leases and purchases. It seems important that the direction of any change in that area is incorporated into the new leases standard.

Questions 3-5: Lessee accounting, lessor accounting, classification of leases

17. The introduction of different accounting approaches for different leases creates new scope for confusion and uncertainty over the definition of 'insignificant'.
18. For sale and leaseback arrangements, the ED proposes to determine whether a sale occurs in accordance with the terms of the draft Revenue standard. The existence of a leaseback is not itself evidence that a sale has occurred. One criterion is that "the present value of the lease payments accounts for substantially all of the fair value of the asset". This means that where a small residual is priced in by the lessor the transaction may not be a sale. Where a sale is deemed *not* to occur, both lessee and lessor are required to account as a financing rather than leasing transaction. This creates distortions and it is therefore suggested that all sale and leasebacks are accounted for by lessors as leases.
19. It should be clear in the standard that the right of use asset is not an intangible asset. Again, the review of the conceptual framework should remove any uncertainty in this area.

Question 5: Lease term

20. Although lease term reassessment requirements have been scaled-back since the previous ED, they remain a significant issue for larger lessees and lessors in particular. Reassessing the lease term for individual leases and lease components could be very cumbersome. A provision allowing such leases to be reviewed on a portfolio basis and only changed if there is a significant change affecting that portfolio would help. New 'hurdles' might be added for when reassessments of individual leases / components were needed, as opposed to reassessment of the portfolio.

Question 6: Variable lease payments

21. Some of the most operationally onerous changes for lessors are likely to be the requirement to value LIBOR-linked or similar variable rate leases using the index rate at the commencement date (70b) and, in particular, the requirement to reassess the lease payments when the index rate changes (79c). These fundamentally change the way lessors account for variable rate leases and so bring into the scope of the ED changes many very simple leases which would otherwise be unaffected, including for only small changes to index rates. It is not clear that this new method of accounting gives improved results, indeed it moves away from the commercial reality of how such leases currently operate.
22. There is currently no difference in the accounting for a fixed rate lease and a variable rate lease (assuming both are match funded by the lessor) because of the operation of the interest variation clauses contained in any variable rate lease. Interest variation adjustments to the contractual rentals mean that the lease reverts back at each rental payment date to the same profile as a fixed rate lease. IAS 17 accounting seems to give an outcome which is sensible and in line with the commercial reality, so the case for change is not clear.

Question 8: Disclosure

23. We are concerned that the proposals could add a great deal of further clutter to accounts. The IASB's Feedback Statement on the Disclosure Forum held in January 2013 noted that preparers may err on the side of caution and 'kitchen-sink' their disclosures. To help address this, it should be made clear that the disclosures set out in the ED will often only be relevant to the more significant leases entered into.

Appendix

In the following pages we attempt to set out as a flowchart the steps that a lessee would need to follow for equipment lease or its components, based on the ED.

Many of the steps would not be relevant in most cases and in most cases would result in no adjustments being made. Nonetheless we expect that auditors would look for evidence that all of the factors contained in them had been considered. Many of the steps could be removed without affecting the numbers in the financial statements.









